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The Soviet Bloc Hard Currency
Problem and the Impact of
Western Credit Restrictions (U)

National Intelligence Council
Memorandum

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This Memorandum was coordinated within the National Intelligence Council and the Directorate of Intelligence. Comments are welcome and may be addressed to its author, Maurice Ernst, National Intelligence Officer for Economics (telephone 351-4128). (u)

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The Soviet Bloc Hard Currency Problem and the Impact of Western Credit Restrictions (U)

Foreword

This paper assesses the potential impact of Western financial measures against Soviet Bloc countries on the capacity of the USSR to import from the West. It examines the hard currency problem of the USSR, that of the East European countries, and the manner in which their problems affect the USSR. It analyzes the role of government-financed and guaranteed credits in the overall flow of Western capital to the Soviet Bloc and the factors affecting the direct and indirect impact of official restrictions on this flow. Attitudes of US allies concerning financial sanctions are treated briefly. The last section deals with some policy implications of the foregoing analysis.

The paper does not evaluate in detail the impact of reductions in hard currency imports on the Soviet economy. This important topic is treated in other studies. Nor does it address possible Soviet Bloc reactions to Western sanctions.

The Soviet Bloc Hard Currency Problem and the Impact of Western Credit Restrictions (U)

Key Judgments

The private financial community has turned very negative about lending to the Soviet Bloc. Private sources of long-term credit to the Bloc have largely dried up.

Western government restrictions on credits to Soviet Bloc countries, if maintained for a period of years, could:

- Moderately reduce the USSR's capacity for hard currency imports in the next few years.
- Force a fall in such imports in the long term, thereby further tightening the resource constraints on the USSR and the difficulty of coping with its defense burden.

The US allies are already in a mood to restrict government-guaranteed credits to the Soviet Bloc for economic reasons; they may be willing to put a ceiling on such credits but not to cut them off or severely curtail them.

The most powerful government instrument for restricting credit to the Soviet Bloc would be placing quantitative limits on government-financed and guaranteed credits. Establishing such limits, even if they involved no absolute decline in the rate of new credits, would be viewed as a negative signal in capital markets, intensifying their disinclination to lend to the Soviet Bloc.

Eastern Europe is in far worse shape than the USSR: this means that Moscow would probably have to share at least a small part of the cost imposed on Eastern Europe by Western restrictions, but could expect no reciprocal help from its Bloc allies if the restrictions were imposed only on the USSR. The USSR could obtain new long-term credit from non-NATO non-Japanese sources only on stringent terms. Most East European countries could receive no such credits.

The Soviet Bloc Hard Currency Problem and the Impact of Western Credit Restrictions (U)

Introduction

A fundamental reassessment of the risk of lending to Soviet Bloc countries has curtailed those countries' access to Western private credit and made some of the remaining credit flows vulnerable to new negative developments. The Soviet hard currency position has worsened greatly in recent months. The USSR is in the midst of a short-term liquidity problem, due partly to bad crops and the Western recession. With large assets (gold reserves of 1,825 tons worth some \$20 billion at a price of \$350 an ounce) and small fixed obligations (long- and medium-term debt service requirements of \$2-2.25 billion a year, or less than 10 percent of merchandise and arms exports), Moscow has the flexibility to cope with this problem. But a fundamental long-term problem will remain—the USSR's hard currency exports are likely to stagnate or fall, with the result that hard currency imports will also stagnate or decline unless the West is prepared to provide substantially more credit than in the past. Eastern Europe's hard currency position is far worse than the USSR's. Most East European countries either cannot meet their hard currency obligations or must make severe economic adjustments to do so.

The severe deterioration of the Soviet and European hard currency positions has been due to the following factors:

- Increasingly evident systemic deficiencies, resulting in declining growth of productivity.
- The logical implications of the rapid accumulation of hard currency debt in past years—a process which obviously could not continue unless hard currency earnings were also growing rapidly, which they are not.
- In the Soviet case, and to a much lesser extent the East European countries, events outside their control (Western recession, bad crops, lower oil and gold prices).

- The Polish political crisis and economic collapse and its fallout.
- The general worsening of East-West relations, especially in the past year.

Western government policies played a role in encouraging the accumulation of Soviet and East European debt by providing credit on easy terms during the 1970s. Without Western government encouragement, private bank exposure would not have increased to the extent that it did. In the past few months, the possibility that Western governments might restrict or discourage credit to Eastern Europe has created added uncertainty in financial markets and has further discouraged bank lending.

The Crisis of 1981-82

Following two years of soaring foreign exchange earnings as a result of the 1979-80 oil price rise and continued increases in arms sales, Moscow suddenly encountered a severe hard currency bind in the latter part of 1981. The Soviets probably expected some worsening in their hard currency position during the year, but the speed of the turnaround appears to have caught them by surprise. The following appears to be a plausible reconstruction of events:

- In the first quarter, Moscow gave Poland nearly \$1 billion in emergency hard currency aid.
- Oil prices unexpectedly began to fall so that Moscow had to revise downward its expected earnings from oil exports.
- A third successive bad grain crop forced Moscow to buy even more grain, meat, and soybeans than had been planned.
- The weakening of the Western economies after the first part of the year reduced the demand for Soviet exports.

These unexpected expenditures and shortfalls were probably responsible for the precipitous decline in Moscow's hard currency assets in foreign banks from \$8.6 billion at the beginning of 1981 to only about \$3.5 billion six months later. The mid-1981 level appears to be the lowest for at least 10 years relative to Soviet hard currency imports, being equivalent to only about one month's imports. Moscow must have concluded that a severe liquidity problem had developed and had to take some drastic action immediately.

The Soviet Policy Reaction

During the final quarter of last year, Moscow took the following steps to quickly improve its hard currency position:

- Selling large amounts of gold, despite a weakening market. After largely staying out of the market for the first three quarters of 1981, Moscow sold an estimated 200 tons between August and the end of 1981 (twice the amount sold in all of 1980) and at least 50 tons through mid-February 1982.
- Increasing its use of short-term credit.
- Severely rationing expenditures for hard currency imports other than food, by requiring additional authorization and controls throughout the Soviet economic decision structure.

Moscow has not entered the Eurodollar market for mid- or long-term nonguaranteed bank credits as it did in 1975 when faced with a similar foreign exchange crunch. One can only speculate as to the reasons. Many Western bankers have been reluctant to make new large Eurodollar syndications to the USSR. Even so, Moscow probably could obtain Eurodollar credits, but on less favorable terms. That it did not do so may be due to a desire to avoid the widespread publicity that such a step would have stimulated in view of the situation in Poland and the tense state of East-West relations generally. There would have been speculation in the Western press that the Soviets were borrowing money to pay off Polish debts; others would have pointed to the borrowing as a

sign of Soviet economic weakness and vulnerability to Western government pressures. In recent months, the Soviets have been investigating borrowing possibilities in Arab banks, apparently with little success as yet.

Short-Term Prospects

The emergency measures adopted late last year almost certainly enabled the Soviets to return their liquid hard currency assets to more normal levels, but did not eliminate the need for various other forms of extraordinary financing to meet expenditures in 1982. Forces beyond Moscow's control are even less favorable to Moscow's hard currency situation this year than they were last year:

- Oil prices are continuing to fall.
- Demand and prices for Soviet exports are probably also falling.
- Moscow's food import bill will probably be a billion dollars or so higher than last year.

Since other major balance-of-payments items—arms sales, service receipts and payments, and so forth—are unlikely to change much, this means that unless nonfood imports are cut very sharply indeed, Moscow will have to sell substantially more gold or borrow more short-term capital than last year.

It is impossible to know what combination of import cuts, short-term borrowing, and gold sales Moscow will select. For example, if the Soviets cut their nonfood imports by 10 percent in volume (which, given higher prices, would mean little change in value), with exports down and food imports up, their trade and current account deficits would be some \$2 billion larger than last year. By selling their net annual gold production of 275 tons, worth a little more than \$3 billion at \$350 an ounce, they would still have to borrow about \$3 billion in short-term credits to cover the deficit. This is by no means infeasible, although the interest cost would be high.

Short-term borrowing is a reasonable means of filling a financial gap for a year or so, but obviously not over much longer periods. Import cuts, too, would be viewed differently as a means of coping with a brief foreign exchange shortfall than as part of a longer term problem. The USSR, like most bureaucracies, tends to spread short-term cuts fairly evenly among users, except for a few priority areas like food. Over a longer period, priorities among different types of imports and their uses would have to be much more carefully worked out.

Moscow probably believes that the foreign exchange bind is partly a temporary phenomenon. There is a reasonable basis for Moscow to hope that Soviet grain crops will return to normal or better, which would make some reduction in food imports possible. In addition, the likely cyclical upswing of the Western economies during 1983-84 should increase both the price of and the demand for Soviet exports. These factors alone could add several billion dollars to meet Moscow's other hard currency needs.

The Long-Term Bind

Even with some likely improvement in the hard currency position during the next year or two, the USSR faces a scarcity of hard currency through the 1980s. The chances are that the volume of Soviet hard currency exports will stagnate or decline during the coming decade. Specifically:

- The volume of Soviet crude oil exports has been declining for three years and, with domestic oil production likely to be at best constant, and at worst in steady decline, it will be extremely difficult to prevent a further drop, and eventually perhaps a complete cessation, of oil exports for hard currency.
- Gas exports will continue to increase—but not on a large scale until the Yamal Pipeline can be completed—which will probably not be before the latter part of the decade. Even then the increase in gas exports will probably less than offset the decline in oil exports.

- Arms exports for hard currency appear to have leveled off for lack of large new clients. Even current large customers, such as Libya, may have to pare purchases if oil export revenues continue to decline.
- Other Soviet exports (wood, metals, manufactures) are likely to stagnate because of supply limitations and Soviet inability to adapt to Western market needs.

Without the Yamal pipeline a sizable decline in exports would be inevitable, even if Moscow redirected some of the gas to its own and Eastern Europe's use in order to free some oil for export to the West. With the pipeline and some good luck in oil development, the volume of hard currency exports may be held about constant.

Moscow's main hope for sizable increases in hard currency earnings would be another large jump in the prices of oil, gas, and gold—in the case of oil, an event that appears unlikely in the next two or three years, but increasingly likely during the second half of the 1980s.

If Soviet hard currency earnings are stable or declining in the long term, Moscow will need to increase its new borrowing from the West to avoid a decline in its hard currency import capacity. Soviet debt service payments will slowly increase, reflecting the past growth of new credits; consequently, if drawings on Western long- and medium-term credits remained constant, the net inflow of long-term Western capital would slowly decline, and import capacity would fall.

A constant or declining hard currency import capacity would pose serious problems for Moscow. In the 1980s slower economic growth will present the Soviet leadership with increasingly tough and politically painful choices in resource allocation and economic management. Annual increments to national output will be too small to simultaneously meet mounting investment requirements, maintain growth in defense spending at the rates of the past, and raise the standard of living. Simply stated, something will have to give. The Soviet need for Western goods and

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technology will therefore increase greatly. Imports can relieve some economic problems by raising the technological level of key Soviet industries and by reducing shortages of grain and such important industrial materials as steel. Western equipment and know-how will be particularly important to raising productivity in the critical machine-building and energy industries. The Soviets must continue importing large amounts of agricultural products and will probably expand their purchases of steel and some other industrial materials.

The East European Hard Currency Problem

East European countries' hard currency problem is far more severe than the USSR's. Their gold and foreign exchange assets are minimal and their debt service obligations are enormous. Leaving aside Poland, which is in a class by itself, East Germany has a debt service ratio above 60 percent, and the rest, except Czechoslovakia, are all above 30 percent. These ratios put the East European countries in the same class as Brazil, Mexico, and Chile, countries with far more flexible economies and generally rapidly increasing export earnings.

Poland aside, the fact is that Romania cannot meet its obligations, and that East Germany could not achieve any substantial reduction in its indebtedness without wrenching economic adjustments. Hungary, too, would have great difficulty reducing its debt. Even if existing debt were just rolled over, the East European economies would at best limp along with little or no economic growth for the next several years. It is important to keep in mind that Western credits played an important role in financing a large increase in investment in nearly all East European countries during the 1970s, and that this investment was an important factor in sustaining tolerable, if generally slow, growth rates. This important prop for inefficient economies has disappeared.

The Soviet-East European Connection

Soviet-East European economic relations rarely involve transfers of hard currency. Last year's Soviet hard currency aid to Poland was clearly viewed as an exceptional step, outside the normal framework of

economic cooperation and aid. Some trade is paid in hard currency, but the net flows are probably small.

More basically, Soviet trade with Eastern Europe helps to knit the Soviet empire together, but at substantial cost to Moscow. By denying East European countries the possibility of developing economies and economic systems that could be reoriented mainly toward the West, Moscow has little choice but to provide some direct and indirect forms of aid. The direct aid is in the form of credits on bilateral account. The indirect aid takes the form of delivery of undervalued Soviet raw materials and foods in return for overvalued East European manufactured goods. Many of the Soviet exports are sold on the world market and some of them, notably oil, are sold to Eastern Europe far below world market price. Most of the East European exports can be sold on world markets only at severe discounts, if at all, but the Soviets pay world market prices for them.

A worsening of the East European hard currency and economic situation is bound to impose additional burdens on the USSR. Moscow simply cannot afford to let the East European countries go begging to the West by themselves, or alternatively to let their economies deteriorate to the point that serious political consequences could follow. Additional Soviet assistance to Eastern Europe may or may not take the form of hard currency, but even if it did not, there would be indirectly an unfavorable impact on the Soviet hard currency position.

The Role of Western Governments

Western governments have encouraged an accumulation of Soviet Bloc hard currency debt to over \$80 billion by providing credits and credit guarantees, often at subsidized interest rates, and, indirectly, by helping to create an atmosphere of East-West relations which fostered the confidence of private lenders. Credits financed or guaranteed by Western governments make up about one-third of the Soviet Bloc's total hard currency debt—with Poland, the USSR, and East Germany having relied the most on such credits. Being generally long term, these credits ac-

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Soviet Bloc Dependency on Western Government-Backed Credits in 1981

Million US \$

	Soviet Bloc	USSR	Poland	Romania	East Germany	Hungary	Czecho- slovakia	Bulgaria
Stocks								
Total hard currency debt	86,575	19,300	26,000	10,700	14,730	8,250	4,620	2,975
Of which:								
Government-backed debt	29,225	8,500	13,500	1,700	3,800	350	900	475
As a percent of total debt	34	40	52	16	26	4	19	16
Flows								
Gross hard currency borrowing	40,024	5,300	10,000	4,274	6,600	4,310	1,930	910
Gross borrowing from government-backed credits	9,215	1,800	5,750	360	700	100	265	140
As a percent of gross borrowing	23	34	58	8	11	2	14	15
As a percent of imports		6	88	5	10	2	6	6
Net change in stock of government-backed debt		+200	+3,100		+300	+50	+50	+35

This table is [redacted]

count for a much smaller part of the current gross inflow of Western capital than of indebtedness—2 to 15 percent, except in Poland and the USSR (see table). Except in Poland, they are financing only 2 to 10 percent of hard currency imports.

As things now stand, no Soviet Bloc country has received any mid- or long-term unguaranteed bank credit for almost a year. Shorter term credit is available, except to Poland and Romania, but on less favorable terms than in the past.

Impact of Western Financial Measures

Western countries can influence the flow of capital to Soviet Bloc countries both directly, by regulating the volume and terms of government-guaranteed credits, and indirectly, by affecting the willingness of the private sector to lend at their own risk. To date, credit restrictions have come entirely from the private sector, and not from any specific Western government action.

Some of the specific actions Western governments might take to curtail the flow of capital to the Soviet Bloc are:

- Tightening the terms on long-term government-guaranteed credits.
- Limiting or reducing government-guaranteed credits by putting a ceiling on new loans.
- Stopping completely the issuance of any new government-guaranteed credits.
- Also halting drawings on existing government-guaranteed credit packages for orders in train and existing lines for future orders.
- Refusing to reschedule existing credits (for example, to Poland and Romania).

The *direct* impact of some such measures would not be severely disruptive. For example:

- A 3-percent increase in interest rates charged on the new government-guaranteed credits—roughly the recent increase in OECD Consensus rates for the USSR—provided at the 1981 annual level would gradually increase interest payments for the USSR by roughly \$60 million a year, assuming a five-year repayment schedule and no grace period in repayments. The cumulative effect of such a policy over a 10-year period, for example, would result in a total increase of interest payments of some \$1.5 billion. For the Bloc as a whole (excluding Poland) the total cumulative impact over 10 years might reach \$2-2.5 billion. The aggregate numbers still pale, however, in face of an East Bloc financing requirement of hundreds of billions of dollars for all of the 1980s.
- A moratorium on new government-guaranteed credits to Soviet Bloc countries would reduce the net flow of Western capital by amounts equal to no more than 5 to 6 percent of the 1981 level of hard currency imports. Moreover, the effects would take some three to five years to be fully felt as the government-guaranteed credits in the pipeline were drawn down.
- Refusal to reschedule Polish or Romanian hard currency delinquencies could force those countries into a default. They would presumably stop all interest payments but their hard currency trade would be temporarily disrupted. The net impact on the current account balance would be small. Private lenders would view such a step as a negative signal.

The greatest potential impact of Western government credit restrictions are of an *indirect* nature. It would come from the political signal such restrictions would convey to private lenders. It is highly unlikely that Western banks would be willing to resume unguaranteed long- and medium-term lending if Western governments were imposing politically motivated limits on government-guaranteed credits. Short-term lending might also contract, depending partly on the credit worthiness of the individual countries.

Western attempts to differentiate between the USSR and Eastern Europe or among East European countries in the application of credit restrictions would have to consider the following:

- The East European countries are in such bad shape that if credit restrictions were aimed at the USSR alone, Moscow could not recoup its losses at the expense of its satellites. By the same token, restrictions aimed also at Eastern Europe would probably force an extra burden on the USSR.
- The imposition of official credit controls against any Soviet Bloc countries would have some negative effects on private willingness to lend to the other countries as well. Hungary is particularly vulnerable to cuts in private lending. Outside the Soviet Bloc, Yugoslavia would be hurt by the fallout.
- A general worsening in the atmosphere for private lending might be offset for selected countries by specific new Western assistance—for example, IMF membership for Hungary.

The impact of restrictions by NATO countries and Japan on credits to the Soviet Bloc could be weakened by increased lending from various capital suppliers—European neutrals, OPEC countries, and so forth. Nearly all alternative sources of credit, however, would be available only on stringent terms, if at all. Most East European countries probably could not get any medium- or long-term credits from private sources. Moscow probably could get some loans, but would be forgoing the interest rate subsidies now being provided by many NATO countries, and, in addition, would be paying large interest premiums to cover political and economic risk. With the worsening of East-West relations and the development of the Polish crisis, Western government credit guarantees have become important for political risk insurance. Few countries are willing to provide such insurance.

Allied Views on Financial Sanctions

West European governments will be receptive to US initiatives for moderate restrictions on credits to the Eastern Bloc countries if such proposals are justified primarily in economic terms. The Europeans are most

likely to be receptive to sound economic arguments pointing to the alarmingly large Soviet Bloc hard currency debts, the weakened economic position of most East Bloc countries, the likelihood of a worsening balance-of-payments situation for the USSR, and the high cost of Western government subsidies. The current payments problems in Poland and Romania—and the high potential cost of honoring export credit guarantees—certainly reinforce such arguments and serve to give a sense of urgency to the situation. There is a reasonable chance of agreement on holding government-guaranteed credits to or below some recent base level.

The degree to which the Allies would be willing to curb lending to the East, cut subsidies, raise interest rates, or shorten maturities is tempered by domestic economic, political, and strategic considerations. The Allies' East-West trade is small relative to total trade but is important for specific industries in each country. In the long term, the Allies still hope to increase their exports to the Soviet Bloc and almost certainly would not be willing to commit themselves to a long-term restrictive credit policy that prevented such an expansion.

Policy Implications

The foreign financial bind facing the Soviets and their East European allies this decade provides an unusual opportunity to use economic means to influence Moscow's behavior. As with most other such leverage possibilities, the impact will be subtle and undramatic, and it could take years before these modest results become apparent.

Successful Western efforts to sustain or tighten the financial bind will make even more difficult the decisions Moscow must make among key priorities—enhancing the military, feeding the population, improving the civilian economy, sustaining its satraps in Eastern Europe, and expanding (or maintaining) its overseas empire. Such an effort thus could make Moscow consider even more carefully undertaking costly new foreign involvements and increase its incentive for arms control negotiations. But it could not force the Soviet regime to take actions which it

believes run counter to its vital national interests—for example, withdrawal from Afghanistan or allowing Poland to slip out of its power orbit, or conceding significant military advantages to the West. At the same time, the Soviet Union could assume a more aggressive stance in foreign areas to show its defiance of Western actions. Over the long term, such policies could also lead the USSR to adopt a more autarkic stance.

Among the various means of crimping the foreign exchange available to the Soviets, the most plausible method seems to be the limitation of new loans to the Soviet Bloc. In addition to the Soviet financial bind, two key factors lead to this conclusion:

- Credit limitations would take advantage of already strong and prevailing political-economic circumstances. The Soviet Bloc has become highly dependent on foreign loans to sustain economic progress and in some cases even to maintain the current level of economic activity. Western governments and especially commercial financial institutions have become less inclined to lend large sums to the Soviet Bloc as they see little hope that the East's economic and financial situation will improve much, as long as current economic policies are pursued. The likely continuation of a Polish crackdown makes selling the idea of credit limitations easier.
- Western cohesion—so necessary for effective economic leverage—stands a much better chance in the case of credit limitations than of other proposals, such as halting the development of the Yamal gas pipeline, greatly reducing Western purchases of Soviet Bloc exports, pushing down the world market prices for key Soviet exports (gold, diamonds, and oil), or embargoing trade with the Soviet Union. Western Europe and Japan would certainly believe they have much less to lose from imposing credit restrictions than from employing these other types of economic leverage.

Although Western nations are at present disinclined to provide the Soviets and their allies with new credits, it is important to put the credit restraints in place now. After the memories of the East European credit problems and of the Polish political repression subside, it will be much harder to achieve credit constraints. Action now also would send a strong signal to Moscow as to the West's cohesion and strength (a factor that would also help overcome the current belief that the Atlantic Alliance is incapable of collective decisions). Finally, it would preserve an important bargaining chip for the future, in the sense that the possibility of expanded credits could be dangled before a pressed Soviet leadership, especially in the post-Brezhnev era.

The kind of restraint on credit most feasible under current conditions is a ceiling on the flow of new credit that would not exceed recent levels rather than a cutoff of all loans or a sharp curtailment of new credits.

- It would be nearly impossible to achieve a unified Western policy stance on the tougher approaches.
- It is not necessary to achieve the more stringent steps to make the financial situation worse for the Soviet Bloc. Even the expected leakage of new credits through third countries or by "cheating" by the Western nations would do little to reduce the impact of credit limitations.
- It would leave open the possibility of imposing more stringent financial credit restrictions in the future.

The best way of achieving credit limitations seems to be through restrictions on government-guaranteed credit.

- Control over government lending is centralized; it would be difficult to regulate the flow of private lending.
- Limits on government-guaranteed credits would curtail private lending to the Soviet Bloc, as they would be viewed as a negative signal in capital markets, intensifying disinclination to lend to the Soviet Bloc.

A companion element of the credit limitations could be the elimination or reduction of the concessional element on government loans to the USSR and its allies. In the past, competitive pressure for export business has induced Western countries to provide loans to the Soviet Bloc at much less than market rates, forcing the taxpayer to pay the difference. Given their budgetary problems, the governments of Europe and Japan might find this a particularly good time to forgo these subsidies.

Finally, establishment of a Western system for limiting credits to the Soviet Bloc would provide a continuing basis for linking East-West economic relations to Soviet political behavior. To make such a system work on a sustained basis, however, would require broad agreement among the major Western powers on basic goals concerning relations with the USSR.

In sum, the key points here are:

- The limiting of new credits to the Eastern Bloc at near recent levels would significantly constrain Soviet policy choices.
- Such credit restraint is all that is politically feasible in terms of the US allies' view of their long-term interests vis-a-vis the Soviet Bloc.
- More stringent credit restraints would be harder to achieve but would have proportionately greater and more immediate consequences for the USSR.